(8)

FILED
FEB 2 - 2007
OFFICE OF THE CLERK
SUPREME COURT, U.S.

No. 06-484

IN THE

Supreme Court of the United States

TELLABS, INCORPORATED AND RICHARD C. NOTEBAERT,
Petitioners,

v.

MAKOR ISSUES & RIGHTS, LTD., ET AL.,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF TECHNET, THE INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA, THE SEMICONDUCTOR INDUSTRY ASSOCIATION, AEA, BAYBIO, THE CALIFORNIA HEALTHCARE INSTITUTE AND THE NATIONAL VENTURE CAPITAL ASSOCIATION AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

BRIAN D. BOYLE
Counsel of Record
JULIA A. BERMAN
O'MELVENY & MYERS LLP
1625 Eye Street, NW
Washington, DC 20006
(202) 383-5300

SETH ARONSON
O'MELVENY & MYERS LLP
400 SOUTH HOPE STREET
LOS ANGELES, CA 90071
(213) 430-6000

MEREDITH LANDY
DALE EDMONDSON
JOSHUA BAKER
O'MELVENY & MYERS LLP
2765 Sand Hill Road
Menlo Park, CA 94025
(650) 473-2600

Counsel for TechNet, the SIA, the ITAA, AeA, BayBio, CHI and the NVCA as Amici Curiae

TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES ii

INTEREST OF *AMICI CURIAE* 1

STATEMENT 5

SUMMARY OF ARGUMENT 9

ARGUMENT 10

I. The Plain Language Of The Reform Act's "Strong Inference" Requirement Compels Rejection Of The Seventh Circuit's Standard 10

II. The Legislative History Confirms Congressional Intent To Screen Out Barely Plausible Claims of Securities Fraud 14

III. The Reform Act's Strict Pleading Standard Comports Fully With The Constitution 16

IV. The Facts Of This Case Demonstrate The Need For Stringent Application Of The Reform Act 19

CONCLUSION 22

TABLE OF AUTHORITIES

Page(s)

CASES

Baltimore & Carolina Line, Inc. v. Redman
295 U.S. 654 (1935) 17

Bennett v. Spear
520 U.S. 154 (1997) 13

Bryant v. Avado Brands, Inc.
187 F.3d 1271 (11th Cir. 1999) 12

DiLeo v. Ernst & Young
901 F.2d 624 (7th Cir. 1990) 19, 20

Dura Pharms., Inc. v. Broudo
544 U.S. 336 (2005) 4

Exxon Mobil Corp. v. Allapattah Servs.
125 S. Ct. 2611 (2005) 11

Fenner & Smith, Inc. v. Dabit
126 S. Ct. 1503 (2006) 6

Gompper v. VISX, Inc.
298 F.3d 893 (9th Cir. 2002) ..... *passim*

Harlow v. Fitzgerald
457 U.S. 800 (1982) 17

Helwig v. Vencor, Inc.
251 F.3d 540 (6th Cir. 2001) 8, 11

In re Advanta Corp.
180 F.3d 525 (3d Cir. 1999) 8, 16

In re Cabletron Sys., Inc.
311 F.3d 11 (1st Cir. 2002) 7

TABLE OF AUTHORITIES
(continued)

Page(s)

In re Comshare Inc. Sec. Litig.
183 F.3d 542 (6th Cir. 1999).....14

In re Credit Suisse First Boston Corp. Analyst Reports Sec. Litig.
431 F.3d 36 (1st Cir. 2005).....11, 13

In re Digital Island Sec. Litig.
357 F.3d 322 (3d Cir. 2004).....7

In re Read-Rite Corp. Sec. Litig.
335 F.3d 843 (9th Cir. 2003).....10

In re Silicon Graphics Inc. Sec. Litig.
183 F.3d 970 (9th Cir. 1999).....20

In re Time Warner Inc. Sec. Litig.
9 F.3d 259 (2d Cir. 1993).....12

In re VISX, Inc. Sec. Litig.
Nos. C 00-0649 CRB, C-00-0815 CM,
2001 WL 210481 (N.D. Cal. February 27,
2001).....10

Jones v. Bock,
___ S. Ct. ___, Nos. 05-7058, 05-7142,
2007 WL 135890 (Jan. 22, 2007).....17

Makor Issues & Rights, Ltd. v. Tellabs, Inc.
437 F.3d 588 (7th Cir. 2006)..... *passim*

Matsuhita Elec. Indus. Co. v. Zenith Radio Corp.
475 U.S. 574 (1986).....19

TABLE OF AUTHORITIES
(continued)

Page(s)

Novak v. Kasaks
216 F.3d 300 (2d Cir. 2000).....8, 16

Ottmann v. Hanger Orthopedic Group, Inc.
353 F.3d 338 (4th Cir. 2003).....11

Pirraglia v. Novell, Inc.
339 F.3d 1182 (10th Cir. 2003).....8, 12

Ronconi v. Larkin
253 F.3d 423 (9th Cir. 2001).....7

Scheuer v. Rhodes
416 U.S. 232 (1974).....17

Swierkiewicz v. Sorema, N.A.
534 U.S. 506 (2002).....17, 18

STATUTES

15 U.S.C. § 78u-4.....18

15 U.S.C. § 78u-4(b).....10

15 U.S.C. § 78u-4(b)(1).....6

15 U.S.C. § 78u-4(b)(2).....6, 7, 9, 10

15 U.S.C. § 78u-4(b)(3).....12

TABLE OF AUTHORITIES
(continued)

Page(s)

RULES & REGULATIONS

Fed. R. Civ. P. 50 17

Fed. R. Civ. P. 56 17

Fed. R. Civ. P. 9(b) 9, 14, 18

Fed. R. Crim. P. 29 19

Fed. R. Evid. 104 17

Fed. R. Evid. 403 17

LEGISLATIVE MATERIALS

141 Cong. Rec. E184 (1995) 5

141 Cong. Rec. H2763 (1995) 4

141 Cong. Rec. S9170
(daily ed. June 27, 1995) 15

141 Cong. Rec. S19146-47 (1995) 5

H.R. Rep. No. 104-369 (1995) (Conf. Rep.),
as reprinted in 1995 U.S.C.C.A.N. 730 ..... *passim*

S. Rep. No. 104-98 (1995), *as reprinted in*
1995 U.S.C.C.A.N. 680 ..... 6, 7

TABLE OF AUTHORITIES
(continued)

Page(s)

OTHER MATERIALS

Message to the House of Representatives Returning Without Approval the "Private Securities Litigation Reform Act of 1995, 31 Weekly Comp. Pres. Doc. 2210 (Dec. 19, 1995) 14, 15

Cornerstone Research, *2006: A Year in Review*, *available at* http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf.....8

Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?* 2003 U. Ill. L. Rev. 913 .....4, 8

INTEREST OF *AMICI CURIAE*[1]

Technology Network ("TechNet") is a network of Chief Executive Officers and senior partners of more than 150 companies in the information technology, biotechnology, venture capital, investment banking and legal industries, representing the heart of the global innovation economy. The association is chartered to promote the growth of the technology industry and the economy. The majority of TechNet's members lead companies that are publicly traded on the NYSE or the NASDAQ. Other members invest in promising new ventures, some of which grow to become industry leaders in their own right. As members and investors in the high technology and biotechnology industries, TechNet's members represent the leading edge of developing, manufacturing, and marketing emerging technologies. The technology industry ranks among the most vibrant sectors in the economy, and provides both a key engine of job creation and a spectrum of new products that improve the lives of people across the nation and the world.

Since 1977, the Semiconductor Industry Association ("SIA") has been a leading voice for the $115 billion U.S. semiconductor industry. Semiconductors are the enabling technology for the information age, and are a key component in everything from computers and cell phones to video games and satellites. Moreover, semiconductor companies are key participants in the global innovation economy, and many semiconductor companies reinvest a quarter of their revenue in research and development and capital expenditures. The U.S. leads the world in semiconductor technology, capturing 46% of the fiercely competitive world market.

---

[1] Both parties have consented to the submission of this brief in letters filed with the Clerk. No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici* and their counsel made a monetary contribution to its preparation or submission.

There are 234,000 people employed in the semiconductor industry in the U.S. The SIA unites all of the nation's major semiconductor companies, who are collectively responsible for more than 85% of semiconductor production in America. The SIA further shapes public policy on issues critical to the industry and provides a spectrum of services to aid members in growing their own businesses.

The Information Technology Association of America (ITAA) provides global public policy, business networking, and national leadership to promote the continued rapid growth of the IT industry. ITAA consists of approximately 325 members throughout the U.S., and is secretariat of the World Information Technology and Services Alliance, a global network of 67 countries' IT associations. ITAA plays a leading role in issues of IT industry concern including information security, taxes and finance policy, digital intellectual property protection, telecommunications competition, workforce and education, immigration, online privacy and consumer protection, government IT procurement, human resources and e-commerce policy. ITAA members range from the smallest IT start-ups to industry leaders in the Internet, software, IT services, digital content, systems integration, telecommunications, and enterprise solution fields.

AeA (formerly the American Electronics Association) is the largest association of high-tech companies in the United States with about 2,500 companies, representing all segments of the technology industry and 1.8 million employees. As a nationwide non-profit trade association, AeA provides a broad range of services in the business and public policy arenas to member companies active in the software, medical device, telecommunications, instrumentation, computer, semiconductor, aerospace, defense, and manufacturing sectors. Founded in 1943, AeA now has eighteen offices across the U.S., as well as offices in Europe and Asia.

The National Venture Capital Association (NVCA) is a trade association that represents the U.S. venture capital industry. It is a member-based organization, which consists of venture capital firms that manage pools of risk equity capital designated to be invested in high growth companies. NVCA's mission is to foster greater understanding of the importance of venture capital to the U.S. economy, and support entrepreneurial activity and innovation. The NVCA represents the public policy interests of the venture capital community, strives to maintain high professional standards, provides reliable industry data, sponsors professional development, and facilitates interaction among its members.

BayBio is an independent, non-profit trade association serving the life science industry in Northern California. BayBio represents more than 350 member organizations engaged in or supportive of the development of life sciences products. BayBio provides these services through representatives in South San Francisco and through coalition partners in Sacramento and Washington, DC. Through advocacy, membership services, programs and more, BayBio brings the world's largest life science community together.

The California Healthcare Institute ("CHI") is a non-profit, public policy research and advocacy organization for California's biomedical industry. Founded in 1993, CHI has more than 200 members, including California's leading biotechnology, medical device and pharmaceutical companies, as well as the state's premier universities and private research institutions. CHI's mission is to advance responsible public policies that promote scientific discovery and foster medical innovation. CHI conducts economic and public policy research, produces industry analyses, develops educational programs, formulates policy, serves as a clearinghouse for information about California's biomedical industry, and

engages in direct advocacy on behalf of the biomedical R&D enterprise and the patient community it serves.

The question presented by this case—the standard for pleading a "strong inference" of fraudulent intent in securities cases governed by the Private Securities Litigation Reform Act of 1995 (the "Reform Act")—is an issue of great importance to *amici*, and to the entire technology community. The Reform Act was calculated to allow valid fraud claims to proceed while blocking "the routine filing of lawsuits against issuers of securities . . . whenever there is a significant change in an issuer's stock price, without regard to any underlying culpability of the issuer." H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730. Because technology stock prices are often highly volatile, as the market potential of emerging technologies fluctuates, technology companies have been frequent targets of abusive securities suits. *See, e.g.*, 141 Cong. Rec. H2763 (1995) (statement of Rep. Cox) ("High-tech and biotech companies have paid 40 percent of the costs of strike suit settlements . . . ."). Even in the post-Reform Act era, companies in the technology industries remain the target of over 40% of all private securities litigation. Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 959. The securities cases before this Court illustrate the frequent targeting of technology companies; both this case and the recent suit against Dura Pharmaceuticals involve information technology or biotechnology companies. *See, e.g., Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005).

In light of the continual litigation against technology companies, it is vital to *amici*, and to the innovation economy itself, that the Reform Act's protections be stringently enforced. As one of the key constituencies that the Reform Act was intended to protect, as well as one of the principal

beneficiaries of a healthy capital market structure, the technology community has a unique perspective on the proper balance between safeguards against litigation abuses and measures to preserve valid claims. The "strong inference" requirement forms a critical part of that balance, which must be fully implemented if the Reform Act is to serve its intended purpose. *Amici* therefore respectfully submit this brief in support of Petitioners.

STATEMENT

Congress passed the Reform Act in response to widespread abuses in securities litigation. Following extensive hearings, Congress found that while meritorious suits may promote "public and global confidence in our capital markets" and help deter wrongdoing, "significant evidence" indicated that these benefits were being "undermined" by frequent meritless suits. H.R. Rep. No. 104-369, at 31 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730. Abuses Congress identified included (1) the routine filing of "cookie cutter" complaints following every stock drop, without regard to an issuer's culpability and with only a "faint hope" that later discovery might produce a "plausible" claim; (2) the targeting of "deep pocket defendants" solely for settlement value; and (3) discovery practices designed to impose "massive costs," making it more economical for defendants to settle than to litigate.[2] H.R. Rep. No. 104-369, at

---

[2] These abuses have "turned out to be a special danger to new companies, particularly high-technology ventures with volatile stock prices. The Country has a strong interest in encouraging these companies and shielding them from a style of legal assault that is not far from extortion." 141 Cong. Rec. S19146-47 (1995) (statement of Sen. D'Amato) (quoting Editorial, *Override the Securities Bill Veto*, Washington Post, Dec. 22, 1995, at A18); *see also* 141 Cong. Rec. E184 (1995) (statement of Rep. Mineta) (litigation costs "result in less capital for the R&D investments U.S. high-tech companies use to maintain their position at the cutting edge of the world market. For these reasons, securities litigation reform is a top priority for our Nation's high technology community.").

31-32 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 730-31; S. Rep. No. 104-98, at 16 (1995), *as reprinted in* 1995 U.S.C.C.A.N. 680, 695. Congress found that as a result of these practices, "innocent parties are often forced to pay exorbitant 'settlements'" with the result that "the issuer's own investors . . . are the ultimate losers." H.R. Rep. No. 104-369, at 32. Congress further concluded that "fear that inaccurate projections will trigger the filing of securities class action lawsuit [sic] has muzzled corporate management," denying investors crucial information. *Id.* at 43. The House Report concluded that through such practices, "the class action device was being used to injure 'the entire U.S. economy.' H.R. Rep. No. 104-369, p. 31 (1995)," *quoted in Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1510 (2006).

Prompted by these findings, a bipartisan Congress enacted "uniform and more stringent pleading requirements" for securities cases. H.R. Rep. No. 104-369, at 41 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 740. These heightened standards, as set forth in the Reform Act, require that a "complaint shall specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, the complaint shall state with particularity all facts on which that belief is formed." 15 U.S.C. § 78u-4(b)(1). More importantly for present purposes, the Reform Act also requires that any securities complaint:

> state with particularity *facts* giving rise to a *strong inference* that the defendant acted with the required state of mind.

15 U.S.C. § 78u-4(b)(2) (emphasis added). In addition, the Reform Act creates a "safe harbor" against liability for com-

panies that disclose valuable forward-looking information. 15 U.S.C. § 78u-5(c). The Reform Act further bars discovery until a complaint is determined to meet the Act's rigorous pleading standards. 15 U.S.C. § 78u-4(b)(3). In so doing, the Reform Act allows properly supported claims to proceed, while screening out improper suits prior to discovery, thus protecting innocent parties from the burdens that had previously been used to force unmerited settlements. *See, e.g.,* H.R. Rep. No. 104-369, at 31-32; S. Rep. No. 104-98, at 16.

As a result of these changes, cases governed by the Reform Act are treated differently than other federal court civil litigation, where notice pleading under the Federal Rules of Civil Procedure suffices. *Ronconi v. Larkin*, 253 F.3d 423, 437 (9th Cir. 2001) (Reform Act effects "an unusual deviation from the usually lenient requirements of federal rules pleading."). The Reform Act expressly requires a securities plaintiff to identify specific facts in order to withstand a motion to dismiss. In most other settings, plaintiffs receive the benefit of all favorable inferences at the pleading stage. Not so under the Reform Act: the allegations must, when taken as a whole, support a *strong* inference of wrongdoing, and cannot stand merely because some rational inference exists that favors plaintiffs. *See, e.g., Gompper v. VISX, Inc.*, 298 F.3d 893, 896-97 (9th Cir. 2002). Accordingly, while facts alleged with specificity are still taken as true at the pleading stage, *see id.* at 896, the Reform Act thus "alters the normal operation of inferences under Fed. R. Civ. P. 12(b)(6)." *In re Digital Island Sec. Litig.*, 357 F.3d 322, 328 (3d Cir. 2004); *In re Cabletron Sys., Inc.*, 311 F.3d 11, 28 (1st Cir. 2002) (same).

Despite the Reform Act's pronouncement of a uniform scienter standard against which allegations should be measured, courts have differed sharply in their application of that

standard. *See* Pet. at 17-25. The Ninth Circuit has recognized that consideration of a "strong inference" necessarily entails evaluating "all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs." *VISX, Inc.*, 298 F.3d at 897. Under this standard, which the First, Fourth, and Sixth Circuits have paralleled, a complaint supports a "strong inference" of scienter only where fraud is the most likely inference on the facts alleged. *See, e.g., id.* (citing *Helwig v. Vencor, Inc.*, 251 F.3d 540, 553 (6th Cir. 2001) (en banc), *cert. dismissed*, 536 U.S. 935 (2002) ("plaintiffs are entitled only to the most plausible of competing inferences"). Other Circuits, however, have declined to apply this rigorous test. The Tenth and Eighth Circuits, for instance, have refused to weigh competing inferences at the pleading stage. *See, e.g., Pirraglia v. Novell, Inc.*, 339 F.3d 1182, 1188 (10th Cir. 2003). The Second Circuit has not directly addressed the issue, but has continued to apply its pre-Reform Act scienter standard (which the Third Circuit has also adopted). *See, e.g., Novak v. Kasaks*, 216 F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp.*, 180 F.3d 525, 534-35 (3d Cir. 1999). Most recently, the Seventh Circuit held in the case at bar that a strong inference arises on "facts from which, if true, a reasonable person *could infer* that the defendant acted" with scienter. *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*, 437 F.3d 588, 602 (7th Cir. 2006) (emphasis added). These conflicting standards, and particularly the Seventh Circuit's approach, have prevented the protections Congress created from being fully realized.[3]

---

[3] Litigation patterns have shifted in response. In the Ninth Circuit, once the most common securities venue, the percentage of suits filed there has declined. *See, e.g.*, Perino, 2003 U. Ill. L. Rev. at 916 (noting "statistically significant" decline in Ninth Circuit filings). In parallel, the Second Circuit—until *Tellabs*, the most plaintiff-friendly post-Reform Act venue—has become the most common forum for such suits. *See, e.g.*, Cornerstone Research, *2006: A Year in Review*, at 15, *available at* http://securities.stanford.edu/clearinghouse_research/2006_YIR/20070102-01.pdf. (Second Circuit had the most filings in 2005 and 2006). This

SUMMARY OF ARGUMENT

To preserve valid claims while combating "significant abuses" in securities cases, the Reform Act requires, among other things, that facts alleged with particularity support a "strong inference" of scienter. 15 U.S.C. § 78u-4(b)(2). This plain language compels reversal here. An inference of fraud is not "strong" if it is less plausible than other inferences arising from the same facts. A court can only determine whether an inference is "strong" by evaluating "all reasonable inferences to be drawn from the allegations, including inferences unfavorable to the plaintiffs," and allowing cases to proceed to the costly discovery phase only where particularized facts support fraud as the most plausible scenario. *VISX*, 298 F.3d at 897. Any lesser standard is flatly inconsistent with the text Congress has chosen, and with the Reform Act's purpose of screening out improper claims at an early stage.

The legislative history confirms that Congress intended to bar suits at the pleading stage where the facts alleged do not strongly suggest fraud. Congress passed the Reform Act precisely because Fed. R. Civ. P. 9(b) had not prevented highly speculative complaints from reaching the discovery stage. The Reform Act expressly elevates the pleading standard above Rule 9(b), and beyond the standards imposed by prior law. Standards that allow securities fraud suits to proceed on inferences that, compared to others available, are implausible, would not accomplish that goal, and would effectively revive the pre-Reform Act regime.

The "strong inference" requirement embodies a careful balance between the goals of protecting against litigation abuses and allowing valid claims to proceed. This balance

---

correlation between suit frequency and pleading standard laxity highlights the continued existence of abuse.

requires that courts consider all logical inferences from particularized facts, and allow cases to proceed only where (at the very least) fraud is a more plausible inference than innocence. The decision below failed to effectuate that balance, and thus should be reversed.

ARGUMENT

I. THE PLAIN LANGUAGE OF THE REFORM ACT'S "STRONG INFERENCE" REQUIREMENT COMPELS REJECTION OF THE SEVENTH CIRCUIT'S STANDARD.

The aim of the Reform Act is to more reliably screen out frivolous securities class actions and prevent them from imposing burdens on the American economy. It accomplishes this by requiring, *inter alia*, that plaintiffs allege particularized facts supporting their claims, and that those facts support a "strong inference" of scienter. 15 U.S.C. §78u-4(b). By providing the standard that the required detailed facts must satisfy, the "strong inference" component of the Reform Act forms an indispensable part of this mechanism.

The plain text of the statute requires more than "a permissible inference" or a "reasonable inference." It requires a "strong inference." 15 U.S.C. § 78u-4(b)(2); *VISX*, 298 F.3d at 897 (rejecting inference that is "reasonable and warranted"). A "strong inference" by definition must be more than the "reasonable" inferences that allowed securities plaintiffs to proceed prior to the Reform Act. *See, e.g., In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843, 848-49 (9th Cir. 2003) (rejecting claims even to the extent facts supported "reasonable" inference of fraud); *In re VISX, Inc. Sec. Litig.*, Nos. C 00-0649 CRB, C-00-0815 CM, 2001 WL 210481 at *3 (N.D. Cal. 2001) (Breyer, J.) ("[S]trong must mean something more than merely 'reasonable.'").

"'Strong inferences' . . . involve deductive reasoning; their strength depends on how closely a conclusion of misconduct follows from a plaintiff's proposition of fact." *Helwig*, 251 F.3d at 553. To evaluate the strength of the connection between facts and a conclusion of fraud that plaintiffs seek to draw from those facts, a court necessarily must review the entirety of the permissible inferences and determine, at a bare minimum, that an inference of fraud is more plausible than those suggesting innocence. *See, e.g., VISX*, 298 F.3d at 897. An inference of fraud cannot be "strong" if the most likely scenario on the facts alleged, and the conclusion that flows most closely from those facts, is non-fraudulent conduct. *See, e.g., id.* (rejecting claims where fraud was less likely than unsuspicious inference). Nor is an inference of fraud "strong" "when, viewed in light of the complaint as a whole, there are legitimate explanations for the behavior that are equally convincing." *In re Credit Suisse First Boston Corp. Analyst Reports Sec. Litig.*, 431 F.3d 36, 49 (1st Cir. 2005); *see also e.g. Ottmann v. Hanger Orthopedic Group, Inc.*, 353 F.3d 338, 350 (4th Cir. 2003) ("Strong inference" did not exist where negligence was as likely as fraud). Accordingly, as a logical matter, a complaint supports a "strong" inference of scienter only where deliberate fraud is the more likely scenario flowing from the facts alleged—as four Circuits have recognized. *Credit Suisse*, 431 F.3d at 49; *Ottman*, 353 F.3d at 350; *Helwig*, 251 F.3d at 553; *VISX*, 298 F.3d at 896-97.

The structure of the Reform Act confirms this reading of the "strong inference" provision. *See, e.g., Exxon Mobil Corp. v. Allapattah Servs.*, 125 S. Ct. 2611, 2620 (2005) (to determine what Congress enacted, court "must examine the statute's text in light of context, structure, and related statutory provisions"). The Reform Act's discovery stay, its command that plaintiffs supply "all facts" supporting their

claims, and its "strong inference" requirement combine to serve a carefully balanced gatekeeping function. *See* 15 U.S.C. §§ 78u-4(b)(1), (2), (3). Together, these provisions allow claims to proceed only where they are founded on particularized allegations showing a strong likelihood of fraud, while preventing speculative claims from being used to support potentially abusive discovery. The purpose of this screening mechanism would be defeated if Congress's language were interpreted to allow plaintiffs to impose discovery burdens based upon fraud inferences that are barely plausible. *See, e.g., VISX*, 298 F.3d at 896-97 ("Congress made it crystal clear that the [Reform Act]'s pleading requirements were put in place so that only complaints with particularized facts giving rise to a strong inference of wrongdoing survive a motion to dismiss . . . .")

The Seventh Circuit's formulation of the standard is impossible to reconcile with the text and structure of the Reform Act. The Seventh Circuit's command that plaintiffs supply "facts from which, if true, a reasonable person could infer that the defendant acted with the required intent," *see Tellabs*, 437 F.3d at 602, effectively applies the pre-Reform Act approach of sustaining claims when any reasonable inference of fraud could support a suit. *See, e.g., In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 270 (2d Cir. 1993) (drawing all inferences in plaintiffs' favor), *superseded by statute as stated in Bryant v. Avado Brands, Inc.*, 187 F.3d 1271, 1286 (11th Cir. 1999). Several other circuits, including the Tenth and Eighth, have similarly declined to weigh competing inferences, and have invoked pre-Reform Act 12(b) jurisprudence in support of a lenient standard. *See, e.g., Novell*, 339 F.3d at 1188 (continuing to draw inferences in plaintiffs' favor based in part on application of traditional 12(b)(6) standard). These approaches are incorrect on multiple grounds. Setting aside the Reform Act's alteration of the framework for pleading challenges, *see supra* at 5, these

constructions "eviscerate the PSLRA's strong inference requirement by allowing plaintiffs to plead in a vacuum." *VISX*, 298 F.3d at 896; *see also, e.g., Credit Suisse*, 431 F.3d at 51 (courts should not "turn a blind eye to the universe of possible conclusions stemming from a given fact or set of facts"). Under these standards, plaintiffs do not even need to supply the full range of particularized facts the Reform Act demands, because they can use improbable but technically possible inferences to fill any gaps in their factual allegations. These approaches invite the illogical conclusion that a "strong inference" does not mean "strong," as the text states, but merely "not impossible." By accepting "reasonable" inferences uncritically, the standard set forth by the Seventh Circuit, and other similarly lenient standards, effectively read the "strong inference" language out of the statute, in direct contravention of "cardinal principle[s] of statutory construction." *Bennett v. Spear*, 520 U.S. 154, 173 (1997) (Court will "give effect, if possible, to every clause and word of a statute") (citations omitted).

Where the facts alleged with particularity show alternate inferences to be as or more likely than fraud, the plaintiff has not satisfied its pleading burden of demonstrating a "strong inference" of securities fraud. The rigorous application of the "strong inference" requirement enables early rejection of claims based on speculative inferences, *see, e.g., VISX*, 298 F.3d 893, while facilitating claims founded on strong inferences drawn from particularized facts. Any more lenient construction would fail to effectuate the Reform Act as written. Given the Reform Act's gatekeeping function, there is no basis for interpreting its "strong inference" requirement to permit plaintiffs to impose discovery burdens where the most plausible inferences are inconsistent with fraud. This Court therefore should reverse the decision below.

II. THE LEGISLATIVE HISTORY CONFIRMS CONGRESSIONAL INTENT TO SCREEN OUT BARELY PLAUSIBLE CLAIMS OF SECURITIES FRAUD

The legislative history confirms what the Reform Act's language compels: that Congress intended to heighten the standard for pleading scienter. Even the Seventh Circuit recognizes that the Reform Act "did unequivocally raise the bar for pleading scienter." *Tellabs*, 437 F.3d at 601.

Congress enacted the Reform Act precisely because Federal Rule of Civil Procedure 9(b) "ha[d] not prevented abuse of the securities laws by private litigants." H. R. Rep. No. 104-369, at 41 (1995) (Conf. Rep.) *as reprinted in* 1995 U.S.C.C.A.N. 730, 740 (quoted in *In re Comshare Inc. Sec. Litig.*, 183 F.3d 542, 548 (6th Cir. 1999)). Congress recognized "a need" to establish "more stringent pleading requirements" to restrict securities suits to meritorious claims, and "to curtail the filing of meritless lawsuits." *Id.* To fulfill that need, Congress expressly elevated the pleading standard beyond Rule 9(b), and beyond anything in existing law. *See* Message to the House of Representatives Returning Without Approval the "Private Securities Litigation Reform Act of 1995," 31 Weekly Comp. Pres. Doc. 2210 (Dec. 19, 1995).

To craft a new and more stringent standard, Congress began with the then-strictest scienter requirement in the nation, which was the Second Circuit's "strong inference" approach. It then went a step further, cautioning that "[b]ecause [it] intend[ed] to strengthen existing pleading requirements, it [did] not intend to codify the Second Circuit's case law interpreting [the "strong inference"] pleading standard." *See* H.R. Rep. No. 104-369, at 41, 48 n.23 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 740, 747. Indeed, while the Senate precursor to the final statute

adopted a full version of the Second Circuit's interpretation of the "strong inference" requirement in substance, the Conference Committee deliberately removed that language to more expressly raise the Reform Act's pleading standard above that established in Second Circuit decisions. *See* H.R. Rep. No. 104-369, at 48 n.23 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 747. The Conference Committee confirmed its decision to adopt a higher standard in its final report, noting Congress's choice "not to include . . . language relating to motive, opportunity, or recklessness" as set forth in Second Circuit opinions. *Id.*

President Clinton recognized the intention to make pleading standards more rigorous than those in force in the Second Circuit in his message to Congress vetoing the Reform Act. *See* Message to the House of Representatives Returning Without Approval the "Private Securities Litigation Reform Act of 1995," 31 Weekly Comp. Pres. Doc. 2210 (Dec. 19, 1995). He indicated that, while he was willing to support a codification of the Second Circuit's pleading standard, it was "crystal clear" that the Reform Act was intended "to raise the pleading standard even beyond that level." *Id.* Congress overrode that veto, and passed the Reform Act—a direct mandate to implement the stringent pleading standard President Clinton and the Conference Committee described.

The Seventh Circuit's standard is impossible to reconcile with this compelling evidence of Congressional intent to enhance scienter pleading standards beyond existing law. *See VISX*, 298 F.3d 893. As noted, the Seventh Circuit's approach, by affording plaintiffs the benefit of all permissible inferences, is no different than the regime that prevailed prior to the Reform Act. *See supra* at 9. Such a construction is thus improper, as are the standards of other Circuits that apply pre-Reform Act law. *See, e.g., Novak v. Kasaks*, 216

F.3d 300, 310 (2d Cir. 2000); *In re Advanta Corp.*, 180 F.3d 524, 534-35 (3d Cir. 1999).[4]

III. THE REFORM ACT'S STRICT PLEADING STANDARD COMPORTS FULLY WITH THE CONSTITUTION

Perhaps recognizing the disconnect between its standard for reviewing securities fraud pleadings and Congress's express intent that federal courts play a more active gatekeeping role, the Seventh Circuit suggests that a stringent construction of "strong inference" might implicate jury trial rights under the Seventh Amendment. *See, e.g., Tellabs*, 437 F.3d at 602. This concern is misplaced. There is nothing unusual or problematic about requiring district courts to enforce a stringent pleading standard of the sort set forth in the Reform Act.

Judges routinely make decisions that either impact or terminate litigation without jury input. Motions to dismiss, motions for summary judgment, *see* Fed. R. Civ. P. 56, and motions for judgment as a matter of law, *see id.* at Rule 50, are all determined by judges without (and in some cases, despite) jury findings. And as a general matter, crucial—even

---

[4] The *Novak* and *Advanta* decisions, which applied the prior Second Circuit scienter standard, based their reasoning on the presence of the term "strong inference" in earlier Second Circuit opinions, and on other comments within the legislative history. *See, e.g., Novak*, 216 F.3d at 311-12. The reasoning of these courts, however, is inconsistent with Congress's rejection of proposals designed simply to codify the Second Circuit's test, with compelling legislative history that the Reform Act did not simply adopt the Second Circuit test, and with the Clinton veto message. The use of the "strong inference" language and surrounding commentary simply shows that Congress found the then-existing highest standard instructive in its attempt to craft a new, even more rigorous standard. In light of the overwhelming evidence suggesting that Congress created a standard higher than the Second Circuit's approach, continued application of pre-Reform Act standards is improper.

dispositive—evidentiary rulings, in criminal as well as civil actions, are made by judges. *See, e.g.*, Fed. R. Evid. 104 (providing for court to determine questions of admissibility), 403 (allowing court to exclude evidence where the risk of undue prejudice outweighs the probative value of the evidence). Such gatekeeping mechanisms are fundamental parts of our judicial system.

It is thus not surprising that judicial enforcement of pleading and other procedural requirements of the kind at issue here have long been held to have no impact on jury trial rights. *See, e.g., Baltimore & Carolina Line, Inc. v. Redman*, 295 U.S. 654, 657 (1935). Every heightened pleading standard is by definition intended to ensure that only selected allegations are permitted to reach a jury for factfinding. Challenges based on a plaintiff's inability to satisfy congressionally-imposed (or even judge-made) pleading standards do not implicate jury trial rights, as "the issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims." *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974), *overruled on other grounds, Harlow v. Fitzgerald*, 457 U.S. 800 (1982). Elevated pleading standards are deeply rooted features of existing law. *See, e.g., Swierkiewicz v. Sorema, N.A.*, 534 U.S. 506, 512-13 (2002) (identifying example of heightened pleading requirements under Rule 9(b)).

Congress unquestionably has the power to create (and modify) the substantive standards for securities fraud claims, just as in other areas of federal law. With this power comes the concomitant power to impose heightened pleading standards. *See, e.g., Jones v. Bock*, ___ S.Ct. ___, Nos. 05-7058, 05-7142, 2007 WL 135890 at *9-10 (Jan. 22, 2007) (recognizing that Congress possessed, but had not exercised, the power to create specific pleading requirement of exhaustion of remedies). What Congress has done here can be analo-

gized to the judge-made rule that permits certain antitrust claimants to get to a jury only if their proffered evidence "tend[s] to exclude the possibility" that the defendants' conduct resulted from independent decision making. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.* 475 U.S. 574, 597 (1986) (internal quotation omitted). By preventing such antitrust plaintiffs from proceeding with claims where the evidence is equally consistent with lawful and unlawful behavior, this rule helps prevent antitrust litigation from chilling independent, and pro-competitive, behavior. *See id.* Similarly, Congress here has required securities plaintiffs to identify specific facts that make an inference of scienter more probable than competing inferences before proceeding in order to prevent speculative fraud claims from imposing burdens on behavior (such as good-faith forward-looking projections) that Congress wishes to encourage.

While there is, of course, a continuum of possible standards, there is no inherent constitutional difficulty with standards at the stringent end of the spectrum. If facts alleged are insufficient to state a claim according to the standard Congress selects, the case ends without any role for a jury or any offense to jury trial rights. Indeed, Rule 9(b) itself reflects that structure: while it compels rejection of cases that satisfy Rule 8's notice pleading standard, it has never been held to offend constitutional principles in doing so. *See, e.g., Swierkiewicz*, 534 U.S. at 513 (recognizing 9(b)'s heightened standard).

The "strong inference" requirement that Congress has imposed here is thus no less defensible than other legislatively- or judicially-established pleading or evidentiary rules. The Reform Act simply requires that to state a cause of action for securities fraud, plaintiffs must allege facts that meet a particularized pleading standard. To be sure, Congress has selected a stringent standard, given the evidence of historical

abuse of the securities class action vehicle. Nevertheless, there is no principled reason why the stringency of this standard (which no Circuit has held to violate due process rights) would cause it to be any less constitutionally sound than other heightened pleading standards.[5]

IV. THE FACTS OF THIS CASE DEMONSTRATE THE NEED FOR STRINGENT APPLICATION OF THE REFORM ACT

"The story in this complaint is familiar in securities litigation. At one time the firm bathes itself in a favorable light. Later the firm discloses that things are less rosy. The plaintiff contends that the difference must be attributable to fraud." *See, e.g., DiLeo v. Ernst & Young*, 901 F.2d 624, 627 (7th Cir. 1990) (dismissing case). Specifically, plaintiffs charge Tellabs' management with making falsely optimistic statements while knowing that Tellabs would not meet expectations. *See Tellabs*, 437 F.3d at 592-593. Yet the complaint lacks allegations placing knowledge of an upcoming miss in the mind of any defendant. With the benefit of hindsight, plaintiffs allege that the CEO overstated demand, and that internal reports existed that identified the demand decline that ultimately came to pass. *See id.* at 603. Plaintiffs do not show that the CEO knew of those reports when he spoke, however. The Seventh Circuit even acknowledges that he may not have known of the decline when he spoke. *Id.* ("[I]t is conceivable that [the CEO] had yet to see the reports suggesting his company was in trouble"). The opinion simply discounts that point on the grounds that "a reasonable person could infer" that the CEO knew of the reports. *Id.* at 602. Accordingly, this case is at its core a common accusation of

---

[5] Congress's power to set a standard it deems proper is particularly broad given that the Section 10(b) cause of action itself, as an implied right of action under a federal statute, exists only due to Congressional acquiescence. *See* 15 U.S.C. § 78u-4.

"fraud by hindsight," with no remarkable features in terms of either theory or supporting fact.

"Congress's basic purpose in raising the bar in the first place" was "to put an end to the practice of pleading fraud by hindsight" in this manner. *VISX*, 298 F.3d at 897. While virtually every company falls short of expectations at some point during its history, disappointment does not equate to fraud. Even before the Reform Act, "[i]nvestors seeking relief under Rule 10b-5 ha[d] to distinguish their situation from that of many others who are adversely affected by business reverses." *DiLeo*, 901 F.2d at 627. In the post-Reform Act era, without specific facts showing that fraud in fact occurred, there is "no way of distinguishing [plaintiffs'] allegations from the countless 'fishing expeditions' which the [Reform Act] was designed to deter." *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 988 (9th Cir. 1999) (dismissing claims).[6] Yet plaintiffs allege no such facts here. Because this case lacks facts that place knowledge of an imminent miss in the mind of the CEO, it falls squarely within the category of strike suits the Reform Act targets.

This case runs afoul of the Reform Act in an additional respect in that it rests on exactly the kind of forward-looking information that Congress sought to encourage companies to disclose without fear of liability. Congress found that "a company's own assessment of its future potential would be among the most valuable information shareholders and potential investors could have about a firm." H.R. Rep. No.

---

[6] Unsupported assertions that warnings in internal reports alerted executives to an imminent miss similarly do not distinguish strike suits from instances of fraud. "[E]very sophisticated corporation uses some kind of internal reporting system reflecting earlier forecasts; allowing [plaintiffs] to go forward with a case based on general allegations of 'negative internal reports' would expose all those companies to securities litigation whenever their stock prices dropped." *Silicon Graphics*, 183 F.3d at 988 (citations and quotations omitted).

104-369, at 43 (1995) (Conf. Rep.), *as reprinted in* 1995 U.S.C.C.A.N. 730, 742. Congress concluded, however, that issuers were declining to provide such information for fear that a failure to meet forecasts would result in a lawsuit. *Id.* The Reform Act was therefore calculated "to enhance market efficiency by encouraging companies to disclose forward-looking information" without fear of open-ended liability in the event that forward-looking statements proved less than prophetic. *See id.* This suit, which criticizes Tellabs for inaccurate forecasting, would create just the kind of disincentive to forthright discussions of future prospects that Congress feared. The "strong inference" requirement, and its ban on suits lacking compelling evidence of fraud, is part of a carefully crafted plan to prevent such an outcome. For the purposes of the Reform Act to be realized, that screening mechanism must be applied according to its terms.

Because this case constitutes exactly the kind of hindsight criticism of forward-looking discussions that Congress enacted the Reform Act to prevent, the consequences of allowing this suit to proceed are impossible to overstate. If the Reform Act were found not to block such suits—despite Congress's clear intent to do so—companies would be effectively returned to the pre-Reform Act regime with all of its attendant abuses. Accordingly, if the goals of Congress are to be achieved, the "strong inference" requirement must be given its due force, and the allegations here must fail.

This is not to say that the Reform Act is so stringent as to bar all claims. As Congress has concluded, anti-fraud protections serve a vital role in maintaining the integrity of the capital markets on which the technology community depends. *See supra* at 2. The Reform Act therefore does not present a barrier to suits where adequate indicia of fraud exist. Even in Circuits that have strictly applied the Reform Act's strong inference requirement, complaints can and do

withstand motions to dismiss. The Reform Act is calculated simply to ensure that the crucial anti-fraud mechanisms of the Securities Exchange Act of 1934 are reserved for non-speculative claims of fraud.

CONCLUSION

It is vitally important for *amici*, for the innovation economy, and for the capital markets themselves, that the Reform Act be implemented as Congress intended. The judgment of the Court of Appeals should be reversed.

Respectfully submitted,

BRIAN D. BOYLE
Counsel of Record
JULIA A. BERMAN
O'MELVENY & MYERS LLP
1625 Eye Street, NW
Washington, DC 20006
(202) 383-5300

SETH ARONSON
O'MELVENY & MYERS LLP
400 SOUTH HOPE STREET
LOS ANGELES, CA 90071
(213) 430-6000

MEREDITH LANDY
DALE EDMONDSON
JOSHUA BAKER
O'MELVENY & MYERS LLP
2765 Sand Hill Road
Menlo Park, CA 94025
(650) 473-2600

Attorneys for TechNet, the SIA, the ITAA, AeA, BayBio, CHI, and NVCA as Amici Curiae

February 9, 2007